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IN THE

Supreme Court of the United States

October Term, 1950

No.....

LOUIS RUBINO,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent,

and

CATHERINE RUBINO,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

To the Honorable
the Supreme Court of the United States:

Your petitioners, Louis Rubino and Catherine Rubino, respectfully pray that a writ of certiorari issue to review the judgment of the United States Court of

Appeals for the Ninth Circuit Court of Appeals for the Ninth Circuit, affirming a decision of the Tax Court of the United States.

Opinions Below

The Tax Court's opinion (R.27-51) is reported at 8 TCM 1095, and the opinion of the Court of Appeals, affirming the decision of the Tax Court (R.99) is reported at 186 Fed (2d) 304.

Jurisdiction

The petition for rehearing was denied by the Court of Appeals for the Ninth Circuit on February 8, 1951. The jurisdiction of this Court is invoked under Section 28 USC 1254.

Questions Presented

1. Whether "property used in the trade or business" which is subject to the allowance for depreciation provided in Sec. 23 (l)(1), Internal Revenue Code, can also be property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

2. Whether Congress intended the exclusionary clause (B), "held primarily for sale to customers in the ordinary course of trade or business" of Sec. 117(j)(1), Internal Revenue Code, as a restriction on the clause referring to property subject to depreciation therein.

Statutes and Regulations Involved

The statutes and regulations involved are as follows:

Internal Revenue Code, Sections 23(l), and 117(j);

Regulations 111, Sections 29.23(l)-2 and 29.117-7.

Said statutes and regulations are set forth to the extent pertinent in the Appendix hereto.

Statement

Petitioners, husband and wife, filed separate returns on the accrual basis for calendar years 1942 and 1943, the years at issue. All income was community income. For convenience, the petitioner husband will hereafter be referred to as Petitioner.

During the years at issue, the Petitioner was primarily engaged in the operation of his wholly owned Alpine Mill and Lumber Co., an individual proprietorship, a retail lumber and milling business. In addition, he was engaged in farming and in the building of houses both for his own account for rent and sale, and on contract for others.

In February of 1942, Petitioner filed, with the Office of Production Management of the United States, applications for priorities for materials to be used in the construction of sixty-two houses for rent to qualified workers in war industries. The applicable regulations provided for the rental basis but did permit the sale of subject houses under certain conditions to the occupants or to other qualified purchasers.

Petitioner sold thirty-three of such houses in the year 1943, ten of which had been completed and held for rent more than six months prior to date of sale. Petitioner reported the gain on the sale of these ten houses as long term capital gain under Section 117(j), Internal Revenue Code, which provides that "property used in the trade or business of a character which is subject to the allowance for depreciation, provided in Section 23(l), held for more than six months, and real property used in the trade or business, held for more than six months, which is not . . . (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business . . . shall . . . be considered as gains from the sale of capital assets held for more than six months". Petitioner so reported the gain on the ground that the foregoing exclusionary clause (B) in Section 117(j), is a limitation on the provisions of that section relating to real property only, and is not a limitation on the provisions of that section relating to property subject to the allowance for depreciation under Section 23(l), Internal Revenue Code. The lower Court found depreciation allowable on these ten houses under Section 23(l), Internal Revenue Code.

The respondent proposed a deficiency upon the ground that the gain realized on the sale of the rental houses was not subject to Section 117(j), Internal Revenue Code, notwithstanding it was conceded that the property in question was subject to the allowance for depreciation. The Respondent was sustained in

proceedings before the Tax Court, and affirmed on appeal by the Court of Appeals for the Ninth Circuit, on a finding of fact that the houses were "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" under Clause (B) of Sec. 117(j)(1), Internal Revenue Code, set out immediately above.

Specification of Errors to be Urged

The Court of Appeals erred:

1. In affirming the decision of the Tax Court of the United States which was based upon inconsistent findings of fact, namely, that the same property could be used in the trade or business under Section 23(l), Internal Revenue Code, and also be held primarily for sale to customers in the ordinary course of trade or business under Section 117(j)(1)(B), Internal Revenue Code.

2. In failing to hold that, as a matter of law, property used in the trade or business subject to depreciation under Section 23(l), Internal Revenue Code, if held more than six months, falls within the definition of property used in the trade or business under Section 117(j), Internal Revenue Code, without any further restriction or limitation.

Reasons for Granting the Writ

1. THE DECISION OF THE COURT OF APPEALS FOR THE NINTH CIRCUIT IS IN CONFLICT IN PRINCIPLE WITH A DECISION OF THE COURT OF APPEALS OF THE FIFTH CIRCUIT.

The attention of the Court is respectfully invited to the case of *Clement W. Delsing and wife Mildred Delsing, Appellant v. United States of America, Appellee,* in the United States Court of Appeals for the Fifth Circuit, — Fed 2nd —, (set out in full in the Appendix, page 27), *reversing* the Tax Court, which had denied relief to the taxpayer under Sec. 117(j), Internal Revenue Code.

It is difficult to distinguish between the controlling facts of the two cases. In each case, in order to secure priorities, it was necessary to agree with the appropriate federal agency to construct the houses for rent, with provision for selling under certain conditions. In each case, after completion, the houses were rented on a month to month basis, and the bulk of the rented houses were sold within one year, rather than over a period of years. In each case, there was accounting segregation of the houses for sale and for rent.

In each case, the Government relied principally upon two facts: The first was a statement in the return with respect to the character of the property. In the *Delsing* case it was stated in the return that "these houses are to be built for sale or rent. The houses will be offered for sale, assuming the permission for this can be obtained from the OPM on the basis, etc." In the present case, affirmed on appeal, the Tax Court (R.35 and R.37) relied on a statement attached to the Petitioner's 1942 return that "During 1942 taxpayers engaged in building homes for sale and on contract", even though it was questionable that this was an

admission of Petitioner of his motive in building these ten houses, which were rented at the time of such statement, or that he had knowledge of the statement, inasmuch as it had been prepared by the accounting firm who prepared the tax return. In the *Delsing* case the Court on appeal felt that the statement was overemphasized by the lower Court in view of the restriction in the formal application securing priorities.

The second fact relied upon by the Government in each of the cases was that the taxpayers' income from sales greatly exceeded their income from rentals. In the *Delsing* case, however the Court on appeal, although recognizing that the taxpayer was very active in building houses for sale, said "The disparity between income from sales and from rentals is not controlling". In the instant case, the Tax Court twice (R.36 and R.39) emphasized that the income from the sale of the houses exceeded the income from rentals, thus clearly relying on the same factor which the Court of Appeals for the Fifth Circuit had held to be not controlling.

The Tax Court in adopting the stipulations (R.28), as a part of its findings, thereby included Petitioner's contract with OPM. That contract provided, in part as follows: "I will not sell, nor will I lease or permit the subleasing of any dwelling unit for more than the applicable amount shown in the schedules under Item 4 or Item 5 above without the prior approval of the Director of Priorities, Office of Production Management, Washington, D. C." (clause 7(b) page 4 of Exhibit 1 of the Stipulations, following R.76), filed in

February, 1942, (R.28). The Tax Court completely ignores the effect of this contract, citing a subsequent NHA order but without showing that such an order was retroactive or a reformation of the original contract.

Since the controlling facts of the instant case are indistinguishable from the facts in the *Delsing* case, supra, it is a fair conclusion that the different decisions obtained are the result of different interpretations of Internal Revenue Code Section 117(j), although neither decision contains any discussion of the law. But whether the decisions on appeal were grounded on conflicting statutory construction of the applicable Internal Revenue Code provisions, or on different interpretations of the facts, despite the fact that the cases are indistinguishable on the facts, the result is that the taxpayer in one jurisdiction is granted the benefits of Section 117(j), Internal Revenue Code, while under the same facts a taxpayer in another jurisdiction is denied the same benefits. The Court of Appeal for the Fifth Circuit reversed the Tax Court decision as not being supported by the evidence, while the Court of Appeal for the Ninth Circuit accepted essentially the same controlling facts as binding upon it. The provisions of the Internal Revenue Code should apply equally to all taxpayers subject thereto.

2. IMPORTANCE OF THE QUESTION INVOLVED.

The legal question involved is whether the exclusionary clauses (A) and (B) of Section 117 (j) (1) are limitations upon depreciable property, as well as

upon real property, as described therein. Section 117(j), Internal Revenue Code, was added by the Revenue Act of 1942 and introduced a new concept of taxation on "Gains . . . from the sale or exchange of certain property used in the trade or business". In no case has this question of law presented herein been squarely met by any Court. The answer to the question will make available, or deny, the relief provisions of Section 117(j) to substantially all cases within its purview. The ultimate effect of a determination by this honorable Court, will be the elimination of inconsistencies of Court decisions, as stated in the previous reason for granting the writ, and the avoidance of inequitable and unequal application of the Internal Revenue laws arising from the absence of an authoritative interpretation of the statute.

An illustration of the present confusion in the Tax Court's interpretation and application of Section 117(j) is found in the recent case of *Differential Steel Car Co. v. Commissioner,* 16 TC-No. 52, promulgated February 23, 1951. There the Tax Court found that "In 1937 a customer contracted with Petitioner for the manufacture of three haulage units". The customer refused delivery because of delay, and Petitioner "continued negotiations with the customer, hoping satisfactorily to consummate the sale". The product was the "same general class of equipment normally manufactured and sold by Petitioner in the regular course of business". The Petitioner used one unit of equipment in his own plant for more than six months

in 1942 and 1943, selling it in 1943 at a profit. The Court, in its opinion, said "Petitioner's argument is that while the equipment in question was initially part of Petitioner's stock in trade, yet, beginning in 1942 and up until the sale in 1943 the equipment was put to use in its business and was thereby converted into 'property used in the trade or business', the conversion dating from the beginning of use in 1942. We see no reason why this contention should not prevail. Cf. *Reginald Denny,* 33 B.T.A. 738 (Dec. 9175); *Leland Hazard,* 7 T.C. 372 (Dec. 15,273); and *Nelson A. Farry,* 13 T.C. 8 (Dec. 17,079). Since the equipment was held in such use for more than six months the gain on its sale should have been treated as a long-term capital gain, and we so hold."

Conclusion

For the foregoing reasons and for the reasons set forth in the brief in support of this Petition, presented herewith, the Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

WAREHAM C. SEAMAN
Seaman & Dick
503 California Building
Stockton, California

Counsel for Petitioner.

Certificate of Counsel

I, the undersigned, **Wareham C. Seaman, counsel** for petitioner herein, hereby certify that in my judgment and opinion the foregoing petition for a Writ of Certiorari is well founded, and that it is not interposed for purpose of delay.

WAREHAM C. SEAMAN

IN THE

Supreme Court of the United States

October Term, 1950

No.....

LOUIS RUBINO,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent,

and

CATHERINE RUBINO,

Petitioner.

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

Summary of Petitioner's Argument

Clear questions of law are presented.

1. The Tax Court could not properly find that the houses in question were held primarily for sale, when it was stipulated and found that they were subject to

an allowance for depreciation under Section 23(l), Internal Revenue Code, which finding was affirmed on appeal.

2. The interpretation of Section 117(j) by the Tax Court, affirmed on appeal, would result in confusion and in a reductio ad absurdem because of the connotation attributed to the word "primarily" in the exclusionary clause "(B) property primarily held for sale to customers in the ordinary course of trade or business."

3. The legislative history of Section 117(j) demonstrates that the exclusionary clause (B), "held primarily for sale to customers in the ordinary course of trade or business", was not intended as a restriction on the clause referring to depreciable property used in the trade or business.

ARGUMENT

I.

The Tax Court could not properly find that the houses in question were held primarily for sale, when it was stipulated and found that they were subject to an allowance for depreciation under Section 23(l), Internal Revenue Code.

It is clear that property "used in the trade or business" cannot be "held primarily for sale to customers in the taxpayers trade or business." Depreciation is allowable on "property used in the trade or business", and not on property held primarily for sale. (See Reg. 111, Sec. 29.32-2, set forth in Appendix). Respondent in this case stipulated that depreciation was allowable

on the rental houses, (R.75), the sale of which is at issue, and the Tax Court found such a fact as stipulated (R.28). Yet the Tax Court, affirmed on appeal, found that these same rental houses were held by Petitioner "primarily for sale to customers in the ordinary course of his trade or business (R.32)".

A stipulation as to the existence of certain facts, acquiesced in or adopted by the Tax Court, and not foreclosing any question of law, cannot be ignored and will not permit a contradictory or inconsistent finding by the same Court on the same fact *(Hackfeld v. United States,* 197 U. S. 442). The stipulation adopted by the Court in its findings in the present case, contains the affidavit by the Petitioner that the houses were to be constructed for rental, and Respondent should be bound by such a statement in the stipulation and should not be allowed to introduce evidence contrary to such statement.

II.

The interpretation of Section 117(j), by the Tax Court, affirmed on appeal, would result in confusion and in a reductio ad absurdem because of the connotation attributed to the word "primarily", in the exclusionary clause "(B), property primarily held for sale to customers in the ordinary course of trade or business."

The interpretation of Section 117(j), Internal Revenue Code, by the Tax Court, necessary to sustain its decision against the Petitioner, would require approval of an interpolation of this section by Respondent. In Reg. 111, Section 29.117-7, there is interpolated

the clause "at the time of the sale", which clause is found nowhere in Section 117(j), Internal Revenue Code. This narrowing of the finding to a moment of time, rather than to a consideration of historical facts also, reads into the statute a requirement not intended by Congress. This would mean that property could be held properly subject to depreciation for a requisite period of time in the past, up to the moment before sale, but at the moment of sale would be instantly converted into property held primarily for sale by the clearest of proof—actual consummation of the sale. The logical application of this interpolation would require the conclusive finding that any property sold was intended for sale at the moment of the sale, unless there was a showing of duress or fraud. The presence of the word "primarily" for sale would be redundant in the event of such an extension of the statute.

To give the word "primarily" its proper connotation in the interpretation of the statute would require a finding that the "holding for sale" was the paramount characteristic of the entire transaction, and would here require a finding of intent inconsistent with the stipulated and found acts and writings. The confusion of the meaning of "primarily" is demonstrated in the instant case by the Tax Court placing the wrong emphasis upon the word "primarily", in the opinion (R.35), affirmed on appeal, where it states, "Of course, the fact that Petitioner was building homes for sale is not controlling, if it can be shown by convincing evidence that such homes were converted to rental prop-

erties and that they were held primarily for that purpose at the time of sale". The issue is not that they were held primarily for rental, but whether they were held primarily for sale, assuming arguendo that such a limitation applies to depreciable property.

III.

The legislative history of Section 117(j) demonstrates that the exclusionary clause (B), "held primarily for sale to customers in the ordinary course of trade or business", was not intended as a restriction on the clause referring to depreciable property used in the trade or business.

The term "capital assets" is defined by exclusion in Section 117(a), Internal Revenue Code. Until 1938, depreciable assets were not excluded from capital assets. In 1938, "(B) Property used in his trade or business of a character which is subject to the allowance for depreciation provided in Section 23(l)" was added as an exclusion from capital assets. Property primarily held for sale to customers in the ordinary course of trade or business had been, and continued to be, excluded from capital assets. Thus Congress in 1938 recognized the distinction and mutual exclusiveness of "depreciable property" and "property primarily held for sale." Otherwise, the amendment was meaningless and futile.

In 1942, Section 117(j) was proposed in Congress. The original House bill provided for "special treatment of gains from the sale of property used in the trade or business subject to depreciation under Section

23(l)" (Secs. 25 and 137(a)-(b), House of Representatives Report No. 2333, 77th Congress, First Edition, July 14, 1942, 1942-2 CB 415, 445, pertinent sections set forth in appendix, page 32)

It will be noted that the Report on sec. 137(a) of the House bill, supra, acknowledged that under the then existing sec. 117(a), Internal Revenue Code, land, as distinguished from improvements subject to depreciation, was a capital asset. The House confined the intent of subsection (a) of sec. 137 of its bill to excepting buildings and improvements from the exclusion, as depreciable assets, from sec. 117(a), Internal Revenue Code, and to treating the buildings and improvements as capital assets. In subsection (b), however, in which it provided for the new sec. 117(j), Internal Revenue Code, the House made no such exception from depreciable assets, requiring only that the property as defined therein qualify for depreciation under sec. 23(l). Nothing was proposed in either subsection altering the allowance of depreciation on buildings used in the trade or business. The result was that the loss on the sale of the buildings would be a capital loss under the proposed subsection (a), of House bill, sec. 137, but the gain on the sale would be treated as a capital gain under either subsection (a) or (b).

The Senate noted this effect, and in order to preserve the deductibility in full of a loss upon sale of depreciable property, proposed in its bill to leave unchanged the exclusion of buildings, subject to de-

preciation, from capital assets, as then provided in sec. 117(a), Internal Revenue Code, and acquiesced in the House's desire to provide similar treatment for land by substituting a proposal that real property be added to sec. 117(a) as an exclusion from capital assets. (Senate Report No. 1631, Seventy-seventh Congress, Second Session Calendar No. 1638. 1942-2 CB 545, 594. Sec. 153(a) and (b). Pertinent sections set forth in Appendix, page 33)

In the Senate report on sec. 153(a) of its bill, it says "This subsection has been changed to provide that *land* used in the trade or business is not within the definition of 'capital assets' . . ." (Italics supplied). The expressed purpose was to give land used in the trade or business the same treatment as property subject to depreciation, *only so far* as amendments to sec. 117(a), Internal Revenue Code, were concerned. The language of both Reports indicates a primary concern for treatment of land, and that the use of the word "real property" referred to "land" rather than "real property" in the strict legal sense.

In defining, for sec. 117(j), "property used in the trade or business," the Senate, introduced and set forth the application of the exclusionary clauses ". . . as property used in the trade or business of a character which is subject to the allowance for depreciation, and real property held for more than six months *which is not properly includible in the inventory . . . or property held by the taxpayer primarily for sale . . .*" This was recognition that

land, which was the objective and justification of the addition of "real property" to secs. 117(a) and inclusion in sec. 117(j), could also be included in inventory and held for sale, whereas depreciable property had been excluded in 1938 from capital assets under 117(a) because the very nature by definition under 23(l) precluded the inclusion of depreciable assets in the category of inventory or property held for sale.

The Conference Report, adds nothing to disclose Congressional intent. (House of Representative Report No. 2586, Seventy-seventh Congress, Second Session. 1942-2 CB 708, Amendment Nos. 149-151, 154)

It is submitted that, properly interpreted, sec. 117(j), defining "property used in the trade or business" therein, means,

(1) *property* used in the trade or business, *of a character which is subject to allowance for depreciation provided in sec. 23(l),*

held for more than six months,

and

(note that it does not say "used in connection with" or "also")

(2) *real property* used in the trade or business, held for more than six months,

which is *not* (A) includible in inventory or

(B) held primarily for sale to customers in ordinary course of trade or business.

Had Congress intended to set forth requirements common to both depreciable property and real property, it is reasonable to conclude that it would not have repeated the phrases "used in the trade or business" and "held for more than six months" as requirements for both classifications, and yet set forth further common requirements as afterthoughts. Mertens, Law of Federal Income Taxation, 22.11a, page 258 (pocket-part 1951,) states "The amendment defines property used in a trade or business as, first, property of a character which is subject to the allowance for depreciation and which has been held more than six months, and second, real estate used in the trade or business held for more than six months, which is not property of a kind which would be included in inventory, or property held by the taxpayer for sale to customers in the ordinary course of his trade or business."

To accomplish the interpretation of Respondent, the Tax Court and the Court of Appeals of the Ninth Circuit, the statute would better read as follows:

> "Section 117(j) applies to property of a character which is subject to allowance for depreciation provided in 23(l) and to real property, provided any such property was
>
> (1) used in the trade or business, and
>
> (2) held for more than six months; but was
>
> (3) not includible in inventory; or
>
> (4) not held primarily for sale to customers in the ordinary course of trade or business.

The section does not so provide:

Conclusion

The decision below indicates conflict in principle with other decisions, is based on an inconsistent finding of fact, is based on an erroneous construction of the statute involved, a highly controversial section of the Internal Revenue Code, and the decision should be reversed.

Respectfully submitted,

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APPENDIX.

Pertinent Sections of Statutes and Regulations Involved.

INTERNAL REVENUE CODE:

Section 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

* * * * * * * * *

(l) Depreciation. — A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

In the case of property held by one person for life with remainder to another person the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

Amended by the 1942 Act.

Sec. 117. Capital Gains and Losses.—

(j) Gains and Losses From Involuntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business.—

(1) *Definition of property used in the trade or business.*—For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l), held for more than 6 months, and real property used in the trade or business, held

for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or (C) a copyright, a literary, musical, or artistic composition, or similar property, held by a taxpayer described in subsection (a) (1) (C). Such term also includes timber with respect to which subsection (k) (1) or (2) is applicable.

(2) *General rule.*—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or as exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For the purposes of this paragraph:

(A) In determining under this paragraph whether gains exceed losses, the gains and losses described therein shall be included only if and to the extent taken into account in computing net income, except that subsections (b) and (d) shall not apply.

(B) Losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion.

Added by the 1942 Act and amended by the 1943 Act. The Revenue Act of 1950 amended Sec. 117 (j) (1) by adding clause (C) to the end of the first sentence, applicable to taxable years beginning after September 23, 1950 (date of enactment).

REGULATIONS:

Sec. 29.23(l)-2. Depreciable property.—The necessity for a depreciation allowance arises from the fact that certain property used in the business, or treated under section 29.23(a)-15 as held by the taxpayer for the production of income, gradually approaches a point where its usefulness is exhausted. The allowance should be confined to property of this nature. In the case of tangible property, it applies to that which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence due to the normal progress of the art, as where machinery or other property must be replaced by a new invention, or due to the inadequacy of the property to the growing needs of the business. It does not apply to inventories or to stock in trade, or to land apart from the improvements or physical development added to it. It does not apply to bodies of minerals which through the process of removal suffer depletion, other provisions for this being made in the Internal Revenue Code. (See sections 23(m) and 114.) Property kept in repair may, nevertheless, be the subject of a depreciation allowance. (See section 29.23(a)-4.) The deduction of an allowance for depreciation is limited to property used in the taxpayer's trade or business, or treated under section 29.23(a)-15 as held by the taxpayer for the production of income. No such allowance may be made in respect of automobiles or other vehicles used solely for pleasure, a building used by the taxpayer solely as his residence, or in respect of furniture or furnishings therein, personal effects, or clothing; but properties and costumes used exclusively in a business, such as a theatrical business, may be the subject of a depreciation allowance.

Sec. 29.117-7. Gains and losses from involuntary conversions and from the sale or exchange of certain property used in the trade or business.—Section 117(j) provides that the recognized gains and losses

(a) from the sale, exchange, or involuntary conversion of property used in the trade or business of the

taxpayer at the time of the sale, exchange, or involuntary conversion, held for more than six months, which is

(1) of a character subject to the allowance for depreciation provided in section 23 (l), or

(2) real property,

provided that such property is not of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or is not held by the taxpayer primarily for sale to customers in the ordinary course of trade or business,

Section 117(j) does not apply to gains and losses on the sale, exchange, or involuntary conversion of any property which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or which is held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, but not including as such property timber which is considered to have been sold or exchanged as provided in section 117(k) (1) or which has been sold as provided in section 117(k)(2). The involuntary conversion of property described in section 117(j) is the conversion of such property into money or other property as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof. . . .

In the United States Court of Appeals
for the Fifth Circuit

No. 13,243. January 5, 1951

CLEMENT W. DELSING AND WIFE, MILDRED DELSING,
Appellants,

vs.

UNITED STATES OF AMERICA,
Appellee.

Appeal from the United States District Court for the Northern District of Texas.

Reversing and remanding the decision of the United States District Court.

Before HUTCHESON, Chief Judge, and

HOLMES and RUSSELL, Circuit Judges.

RUSSELL, Circuit Judge: In this suit to enforce refund of income taxes, in the District Court the parties by stipulation submitted as the sole issue, whether the profit from the sale of Twelve and one-half duplex dwelling units should be treated as capital gain under the provisions of Section 117(j) (1) (B) of the Internal Revenue Code, or ordinary income, with determination of this in turn restricted to whether such property was or was not held "primarily for sale to customers in the ordinary course" of the plaintiff taxpayers' "trade or business." Upon evidence presented by stipulation, and by the oral testimony of

the taxpayer, the trial Court found "the facts to be as stipulated by the parties plus the fact that these properties were originally constructed for sale, or, rental, and, that that course of sale was in the regular course of business when they were sold," and entered judgment for the government. Thus the sole question here presented is whether the finding is supported by the evidence, or whether it should be set aside as clearly erroneous.

We have concluded that the finding of the Court has no sufficient support in the evidence, is therefore clearly erroneous, and must be set aside.

Without attempting to fully detail the facts, it is sufficient to say that the general factual situation relied upon by the taxpayer is that though he, in partnership with another, had for several years prior to World War II been engaged in a substantial business of construction of homes for sale,—which sales were always consummated prior to or upon completion of the houses,—as the result of solicitation of officials of the Federal Housing Administration in their effort to provide defense rental housing units for war workers in the North Texas area, constructed forty-five defense rental units. In order to construct the housing units it was necessary to secure priorities, and as a result of application for preference ratings, made in March, 1942, the taxpayer and the partnership were required to and did agree to construct the houses for rent at fixed monthly rental to persons engaged in war activities, and further agreed not to dispose, or contract for

disposal, except in accordance with defined regulations which, as amended, required taxpayer to hold the duplex houses here involved for rent at rentals authorized, and further to rent only to eligible war workers. This order provided that the war worker tenant could purchase the duplex after a minimum period of four months, later reduced to two months, on specified terms. After completion the housing units were rented to war workers on a month to month basis, and continued to be rented until August of 1945 when occurred the first of the sales now involved, and the remainder of which were consummated in October and December of 1945.[1] By agency regulation, on and after August, 1943, taxpayer could have sold one-third of the entire defense rental project, but he at no time made any effort to secure approval or to sell any of the units until solicited by returning service men in 1945 to whom he made the sales referred to. To service the rental units the taxpayer maintained a rental office and also devoted a major portion of his time to the operation and management of the properties in performing the activities customary in connection with rental properties. There was a complete segregation of bookkeeping entries and accounting between the income from rental property and the house construction and sales activities of taxpayer. From 1942 to 1945, these latter related only to some 273 defense housing units constructed for sale in 1944 by a different partnership of which taxpayer was a member. After

[1] The partnership was dissolved in May, 1944, at which time taxpayer received title to twenty-two and one-half of the duplexes and continued after 1945 to rent the remaining ten.

1945 the construction exclusively for sale business of taxpayer was likewise segregated. Profit from these sales was reported as ordinary income. No "for sale" or advertisements were placed as to any of the claimed rental property. This was in direct contrast with the sale procedure employed in procuring sales of other property constructed for sale in the period 1945 to 1948. In the latter instance, as was generally true in disposing of houses constructed for sale, the sales were effectuated by a real estate agent. Taxpayer was not a licensed real estate agent.

The only facts relied upon by the government, which could be considered at all material, to controvert and overthrow the taxpayer's position as above summarized, are the statements in a letter written by the taxpayer in January of 1942 to the Federal Housing Administration, apparently as a part of an application for insured loans that "these houses are to be built for sale or rent. The houses will be offered for sale, assuming permission for this can be obtained from the O. P. M., on the basis," etc., together with the fact that during the years in question the taxpayer's income from sales, his usual business, greatly exceeded his income from rentals.

It is apparent from the finding of the trial Court that much weight was given to the statement of intention contained in the letter referred to, and also to the admitted fact that the taxpayer's sales activities constituted his major activity, and from this the Court found that any sale of real estate by him was in the

ordinary course of his business. We think the weight to be given to the statement in the letter has been overemphasized in view of the subsequent restriction embodied in the formal application and agreement under which the houses were actually built, held, and operated by the taxpayer during the period of approximately three years. The disparity between income from sales and from rentals is not controlling. Under the facts and circumstances of this case, we find no permissible basis for a determination that the sales of the originally constructed defense rental housing units constituted a disposition of "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business," so as to render the profit taxable as ordinary income[2].

We think the transactions evidenced the sale of capital assets and that accordingly the judgment must be, and is reversed and the cause remanded with direction to enter judgment in favor of the taxpayer for the amount of the refund claimed.

Reversed.

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2 Compare Dunlap v. Oldham Lumber Company, 178 Fed. (2d) 781 [50-1 USTC ¶ 9134].

COMMITTEE REPORTS.

REVENUE ACT OF 1942.

(House of Representatives Report No. 2333, Seventy-seventh Congress, First Session)

(July 14, 1942.)

As Found in 1942-2 Cumulative Bulletin
Page 415

GAINS AND LOSSES FROM INVOLUNTARY CONVERSIONS FROM THE SALE OR EXCHANGE OF CERTAIN DEPRECIABLE PROPERTY

Under existing law, the gain or loss from the sale or exchange of depreciable property is not treated as a capital gain or capital loss, but as an ordinary gain or an ordinary loss. This rule was originally inserted as a relief provision to enable corporations to have the full benefit of a loss from the sale of machinery, instead of being limited by the capital loss provisions, which would permit it only a certain percentage of the loss. It was felt at that time that the taxpayer should not be denied the full loss because it sold the property at a loss instead of abandoning the property. While this rule provided relief in case a loss was realized, it appears that many taxpayers are able to dispose of their depreciable property at a gain over its depreciated cost. To treat such a gain as an ordinary gain will result in an undue hardship to the taxpayer. . . .
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SECTION 137. REAL PROPERTY IMPROVEMENTS; INVOLUNTARY CONVERSIONS: ETC.

(A) Real Property Improvements Treated As Capital Assets

Under existing law, property used in a trade or business of a character which is subject to the allowance

for depreciation is excluded from the definition of "capital assets" in section 117(a). The amendment made by section 137(a) excepts from this exclusion buildings and similar real property improvements, so that such buildings and improvements will be treated as capital assets in the same manner as land. . . .

(B) Gains and Losses From Involuntary Conversion and From the Sale or Exchange of Certain Depreciable Property

Gain or loss on the sale, exchange, or involuntary conversion of property used in the trade or business of a character subject to the allowance for depreciation under section 23(l) is treated under existing law as ordinary gain or loss, and in the application of the provisions of section 117 the fact that a gain or loss results from an involuntary conversion is immaterial. Section 117(j) as added by section 137(b) of the bill provides special treatment for the gains and losses upon the sale or exchange of depreciable property (as defined in that subsection) and the gains and losses upon the compulsory or involuntary conversion of such depreciable property and of capital assets held for more than 15 months. . .

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(Senate Report No. 1631, Seventy-seventh Congress, Second Session. Calendar No. 1683.)

(October 2, 1942.)

As Found in 1942-2 Cumulative Bulletin
Page 545

CAPITAL GAINS AND LOSSES.

(2) Under the House bill losses from the sale of real property and buildings were treated as capital losses, even though the property was used in the trade or business. Your committee has changed this rule by taking buildings and real estate used in the trade or business of the taxpayer out of the definition of capital

assets, and applying to them the same rule which the House bill applies to gains and losses from involuntary conversions from the sale or exchange of certain depreciable property. . . .

The bill defines property used in a trade or business as property used in the trade or business of a character which is subject to the allowance for depreciation, and real property held for more than six months which is not properly includible in the inventory of the taxpayer if on hand at the close of the taxable year or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. . . .
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SECTION 153. REAL PROPERTY IMPROVEMENTS; INVOLUNTARY CONVERSION; ETC.

(A) Real Property, Used in the Trade or Business, Not Treated as a Capital Asset.

Subsection (a) of this section, in the House bill, included real property improvements, used in the trade or business and subject to an allowance for depreciation, within the definition of "capital assets" in section 117(a), so that such improvements would have the same character for tax purposes as the land on which they stand. While your committee believes it desirable for the land and the improvements to have the same character, it considers it more appropriate to treat all property used in the trade or business alike, and not to distinguish between land and other property used in the trade or business. Accordingly, this subsection has been changed to provide that land used in the trade or business is not within the definition of "capital assets" in section 117(a), and will therefore have the same character as improvements subject to an allowance for depreciation, which under existing law are excepted from that definition. In accordance with this policy, changes have also been made in subsection (b) of this section, relating to the treatment of gains

and losses on the sale, exchange, and involuntary conversion of depreciable property, to subject to such treatment land used in the trade or business.

(B) Gains and Losses From Involutary Conversion and From the Sale or Exchange of Certain Depreciable Property and Land.

Section 117(j), as added to the Internal Revenue Code by subsection (b) of this section, provides special treatment for the gains and losses upon the sale or exchange of depreciable property and of land, held for more than six months, and for the gains and losses upon the compulsory or involuntary conversion of such depreciable property and land and of capital assets held for more than six months . . .